



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 6, 1999

CC:EBEO:Br4

Number: **199940014**

Release Date: 10/8/1999

UILC: 457.01-00 457.05-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Assistant Chief Counsel
(Employee Benefits and Exempt Organizations)

SUBJECT:

This Field Service Advice responds to your memorandum dated April 6, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Company =

Date 1 =

Date 2 =

Plan A =

Plan B =

Plan C =

ISSUE:

Whether, under the rules of I.R.C. § 83, Company may deduct the compensation income resulting from its employees' exercise of nonstatutory options on its returns filed for its taxable years during which the options were exercised (Company's normal method of accounting).

CONCLUSION:

Company may deduct the compensation income on its returns filed for its taxable years during which the options were exercised only to the extent that the stock transferred upon exercise was substantially vested when transferred. To the extent that the stock was not substantially vested when transferred, the general rule of section 83(h) governed the timing of the deductions.

FACTS:

Company is an accrual method taxpayer whose taxable years in question ended on Date 1 and Date 2. Under Plan A, Plan B, and Plan C, Company granted nonstatutory options for its common stock to its employees. None of the options had a readily ascertainable fair market value when granted.

Some of the options were exercised during Company's taxable year ending on Date 1, and Company deducted the excess of the fair market value of the optioned stock on the date of exercise over the amount that the employee paid for the stock as a compensation expense on its return filed for that year. Options were also exercised during Company's taxable year ending on Date 2, and Company identically computed and deducted the compensation expenses attributable to those options on its return filed for that year. Company included the corresponding amounts of compensation income on timely-issued Forms W-2.

Examination proposes to disallow Company's deductions on the basis that the stock transferred to Company's employees upon exercise of their options was not substantially vested when transferred. If Exam is correct, the result would be that the deductions would be allowed only under the general timing rule of section 83(h) and Treas. Reg. § 1.83-6(a)(1). In contrast, Company argues that the stock was substantially vested upon transfer, with the result that the deductions were allowable in accordance with its normal method of accounting under the special timing rule of section 1.83-6(a)(3) of the regulations. Your office proposes to advise Exam that Company's analysis is correct.

LAW AND ANALYSIS:

Under section 83(a), if, in connection with the performance of services, property is transferred to any person other than the service recipient, the excess of

the fair market value of the property, on the first day that the rights to the property are transferable or not subject to a substantial risk of forfeiture ("substantially vested"), over the amount paid for the property is included in the service provider's gross income for the taxable year which includes that day.

For purposes of section 83, a "transfer" of property occurs when a person acquires a beneficial ownership interest in the property (disregarding any "lapse restriction," as defined in section 1.83-3(i) of the regulations). See section 1.83-3(a)(1). Property is "substantially vested" when it is either not subject to a substantial risk of forfeiture or is transferrable. See section 1.83-3(b).

Whether a risk of forfeiture is substantial depends on the facts. A substantial risk of forfeiture exists when retention of the rights in property that are transferred is conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person or the occurrence of a condition related to the purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Property is not subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of the property to the employee upon return of the property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, is not a substantial risk of forfeiture. See section 1.83-3(c)(1) of the regulations.

Under section 83(c)(1) of the Code, if the sale of property at a profit could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, the person's rights in the property are treated as subject to a substantial risk of forfeiture and as not transferable.

For purposes of section 83, the rights of a person in property are "transferable" if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the transferee's rights in the property are not subject to a substantial risk of forfeiture. Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of the property and if the transferee is not required to give up the property or its value in the event that the substantial risk of forfeiture materializes. See section 1.83-3(d) of the regulations.

Section 83(b) of the Code and section 1.83-2(a) of the regulations provide that, if property is transferred in connection with the performance of services, the service provider may elect to include in gross income the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in section 1.83-3(i)) over the amount (if any) paid

for the property, as compensation for services. If this election is made, the substantial-vesting rules of section 83(a) and the regulations thereunder do not apply to the property, and (with an exception not applicable here) any subsequent appreciation in the value of the property is not taxable as compensation to the service provider. Thus, the value of property with respect to which a section 83(b) election is made is includible in gross income as of the date that the property is transferred, even though the property is substantially nonvested when transferred, and no compensation is includible in gross income when the property becomes substantially vested.

Section 83(e)(3) provides that section 83 does not apply to the transfer of an option without a readily ascertainable fair market value. However, section 83 does apply to such an option at the time that it is exercised, sold, or otherwise disposed of. If the option is exercised, section 83(a) applies to the transfer of property pursuant to the exercise. If the option is sold or otherwise disposed of in an arm's length transaction, section 83(a) applies to the transfer of money or other property received in the same manner as it would have applied to the transfer of property pursuant to an exercise of the option. See section 1.83-7(a).

Under section 83(h), the service recipient is allowed a compensation expense deduction, under section 162, equal to the amount included in the service provider's gross income under section 83(a). Generally, the deduction is allowed for the service recipient's taxable year in which or with which ends the service provider's taxable year in which the amount is included in gross income. However, section 1.83-6(a)(3) of the regulations provides an exception to the general timing rule for the deduction: if the property is substantially vested upon transfer, the deduction is allowed under the service recipient's normal method of accounting.

With regard to the nonstatutory options granted under Plan A, we note that the prospectus explaining Plan A effectively advises optionees who are subject to section 16(b) of the Securities Exchange Act of 1934 that their stock is substantially nonvested when transferred (see page 10 of the prospectus and the discussion of section 83(c)(1) above). Accordingly, the compensation income attributable to the exercise of their options was deductible under the general timing rule of section 83(h), not the special rule of section 1.83-6(a)(3). In this regard, even if such optionees filed section 83(b) elections with respect to their stock, such stock was, nevertheless, substantially nonvested when transferred for purposes of section 83(h). Thus, section 1.83-6(a)(3) was unavailable for their stock. In contrast, with regard to optionees not subject to section 16(b), we can find nothing in the materials submitted for our consideration to support the conclusion that the stock transferred to them upon exercise of options granted to them under Plan A was substantially nonvested when transferred. Accordingly, section 1.83-6(a)(3) was available for their stock.

With regard to the nonstatutory options granted under Plan B, we note that the Company memorandum dated December 13, 1995, advises optionees in Item #12 that, upon transfer to the optionee's account, the optioned shares will be "unrestricted," and that there is nothing in Plan B that supports the conclusion that the shares were substantially nonvested when transferred. Rather, as best we can tell, stock transferred upon the exercise of options granted under Plan B was substantially vested when transferred, and the compensation income attributable thereto was deductible under section 1.83-6(a)(3).

With regard to the nonstatutory options granted under Plan C, we note that, although Section 1.18 of the Plan defines "Restricted Stock," stock transferred pursuant to the tandem "Option" (Section 1.14) that comprises a "Unit" (Section 1.21) with the Restricted Stock is not referenced in either Section 1.18 or in Article IV ("Restricted Stock"). Additionally, no other facts have been presented to us that would support the conclusion that stock transferred upon the exercise of Plan C Options was substantially nonvested when transferred. Accordingly, as best we can tell, section 1.83-6(a)(3) was available for stock transferred upon the exercise of Plan C Options.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



If you have any questions about this memorandum, please call (202) 622-6060.

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